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No. 92-1586

In The

Supreme Court of the United States

October Term, 1992

DEAN WITTER REYNOLDS, INC.,
a corporation,

Petitioner,

v.

HUDSON T. HARRISON and HARRISON CONSTRUCTION INCORPORATED, a corporation,

Respondents.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

RESPONDENTS' BRIEF IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether a broker-dealer may be held liable under Section 20(a) of the Securities Exchange Act of 1934 for acts of fraud perpetrated by registered salespersons operating from the broker dealer's office over a 30-month period where the registered salespersons:

   (a) represented to more than 100 investors that the broker-dealer permitted them to solicit and invest funds in a broker-dealer authorized program;

   (b) convinced these investors that those representations were true; and

   (c) applied the funds received from investors who relied on those representation to tens of thousands of highly speculative transactions over a period of nearly three years in the registered salespersons' personal accounts with the broker-dealer?

2. Whether a broker-dealer's claim of "good faith" may be established on its motion for summary judgment when plaintiff has shown the facts to be as described in Question 1.

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RESPONDENTS' BRIEF IN OPPOSITION

The opinion of the United States Court of Appeals for the Seventh Circuit is reported at 974 F.2d 873 (7th Cir. 1992). The opinion of the United States District Court for the Northern District of Illinois is reported a 715 F.Supp.

1425 (N.D. Ill. 1989). These opinions are included as Appendix A and B of Dean Witter's Petition.[1]

JURISDICTION

Petitioner has correctly stated the grounds on which it seeks to invoke the jurisdiction of the Supreme Court.

STATUTE INVOLVED

Section 20(a) of the Securities Exchange Act of 1934, 15 U.S.C. §78t(a), is the statute involved, and is correctly set forth in the Petition.

STATEMENT OF THE CASE

The case involves the duties imposed upon a broker-dealer and its "control persons" to protect public investors from injury inflicted by persons the broker-dealer hires and controls. The decision of the Seventh Circuit applying Section 20(a) of the Securities Exchange Act of 1934 in this case is consistent with the application of Section 20(a) by all circuits. A broker-dealer's control persons are required to exercise stringent supervision

[1] **Citations to Record:** References to the Witter petition for certiorari are (P.___), to the petition's appendices (P.App.___), to Plaintiff-Appellant's Appendix in the Seventh Circuit (App. ___), to the various depositions are John Kenning (K.___), John Carpenter (C.___), Richard Frost (F.___), Hudson T. Harrison (H.___), Alfred Rauschmann (R.___).

over the firm's salespeople. *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1301 (2d Cir. 1973).

Dean Witter Reynolds, Inc. employed John Kenning as a Vice-President. While serving as such Witter Vice-President, Kenning initiated and maintained a massive securities fraud scheme which he conducted from the Witter branch office in Boca Raton, Florida. This fraud duped 125 victims over a period of two and one-half years (January 1984 to July 1986). These 125 people invested the aggregate sum of $7.5 million. (App. 94-95). The plaintiffs[2] were among the last victims taken in by the fraud, Mr. Harrison having been "sold" in March 1985; however, Mr. Harrison sustained the largest loss of any victim, $3,229,000.[3] (App. 87, 94-95).

Kenning told Mr. Harrison, and the 125 other investors that their money was invested at Witter in a specially available municipal bond fund. (P.App. 2). In fact, and unknown to any victims, there was no municipal bond fund, and no municipal bonds were purchased. (K. 70). The concealed truth was that Kenning invested more than one-half of all of the fraudulently obtained funds in purchases of put options against Standard & Poors 100 Index futures contracts ("OEX puts"). These purchases were made in a Witter account in the name of Kenning's 25

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[2] In addition to the parties listed in the caption of the case, Thomas P. Ward was a party to the proceeding in the court whose judgment petitioner seeks to review (See P.App. 21-25). There are no parent companies or subsidiaries of Harrison Construction Incorporated.

[3] Harrison lost $2,166,953, and the corporation lost an additional $1,062,200. (First Am. Comp. 20(a) and (b), 28).

year-old associate, John Carpenter (the "Carpenter Account"). (K. 75-77; C. 34).

Carpenter and Kenning shared the same office in the Witter branch and shared the same book of customer business. (F. 784, K. 247). The share of gross income payable on all business was divided by Witter between the two "partners". (Pl. Ex. 55). The OEX put purchases, made through Witter and cleared in Carpenter's Witter account, were each cleared by the branch manager, Mr. Frost. (F. 654, 672-73). From inception until Kenning and Carpenter notified Witter of their fraud in July 1986, they bought 97,000 put contracts through Witter, upon which the "Carpenter Account" showed a $1,844,000 loss; Witter's gross revenue/income on these transactions was $428,000. (App. 99). Virtually every dollar that passed through the account came from one or more of the 125 victims. (K. 291).

Kenning made all buy-sell decisions on the Carpenter Account, though Witter knew he was not the source of any funds. (C. 198). Kenning had filed for bankruptcy, informed Frost of this (K. 98), and received his discharge in bankruptcy, all while he continued his daily activities as a Witter Vice-President. (F. 764-65, App. 137-143).

Kenning assured the investor-victims that there was no intent to "cheat" Witter out of bond mark-ups. Harrison and the others were all told that low transaction costs were one reason these pool participations produced higher-than-normal profits, but that Witter was willing to forgo mark-ups in this situation to attract and keep large producers such as himself. (Harrison Affidavit, 1/9/89). Kenning's explanation for the high rate of promised

return (which was substantially less than the "18% to 60%" referred to; P. 3), was that Witter's bond traders always selected bond issues they could buy at a price slightly below par within 90 to 180 days of redemption, or of a "call" date. (K. 69-70). Then when the bonds were called, the issuer paid a premium which was added to the accrued tax-free interest.

The two-and-one-half year fraud ended in July 1986 when Kenning and Carpenter resigned. They went to the United States Attorney, pleaded guilty, and received jail sentences (Kenning's was eight years, Carpenter's four). Harrison filed suit in October 1986.

REASONS WRIT SHOULD BE DENIED

I. STANDARD APPLICABLE IN SECTION 20(a) LITIGATION

A plaintiff establishes the element of control under §20(a) by supporting his claim with evidence that (1) the alleged control person actually participated in, that is, exercised control over the operations of the person in general, and (2) the control person had the power or ability to control the specific activity upon which the primary violation was predicated, whether or not the power was exercised. The Seventh Circuit's endorsement of this standard (P.App. 12) is consistent with the standard applied by every circuit. The Seventh Circuit held that the existence of "control", in this situation, is to be determined by the trier of fact applying the above standard. (P.App. 13). Where the fraud perpetrators were registered representatives employed by the broker-dealer

while they were conducting the fraud, a motion for summary judgment by the broker-dealer would fail.

II. NO CONFLICT AMONG THE CIRCUITS EXISTS

Every circuit has expressly or impliedly applied the same standard to determine the question of "control". A defendant is a "controlling person" under §20(a) if it has only some direct means of discipline or influence short of actual direction; there is no requirement that the defendant must have actually participated in the primary violation. *First Interstate Bank of Denver, N.A. v. Pring*, 969 F.2d 891, 896, 897 (10th Cir. 1992); *Metge v. Baehler*, 762 F.2d 621, 631 (8th Cir. 1985). Neither does a control person escape liability on a showing that it had no knowledge of the perpetrator's fraudulent activities. As the court noted in *Donahoe v. Consolidated Operating & Prod. Corp.*, 982 F.2d 1130, 1138 (7th Cir. 1992):

> If the rule were otherwise, [control persons] could escape control liability by remaining as ignorant as possible – surely not the result that Congress intended.

The SEC's definition of control is to the same effect. 17 C.F.R. §230.405 (1992).

Except for a 1978 opinion by the Ninth Circuit, which has since been overruled, all reported cases hold broker-dealers are "control persons" in respect to fraudulent acts

of employees perpetrated while the broker-dealer employed them.[4]

In any broker-dealer situation, the element of "control" is not affected by a claim that the employee-perpetrator was acting for his own purposes, that he was attempting to conceal his fraud from his employer, or that his acts of fraud violated broker-dealer rules.[5] *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564 (9th Cir. 1990), held a broker-dealer subject to §20(a) liability because it registered, though it did not employ, the wrongdoer who was an independent contractor. *Id.* at 1574. Titan asserted that it did not exercise any control over the individual it had registered, and that it knew nothing of his conversion of investors' funds (some checks were made out to him personally at his request, and the broker-dealer did not benefit from the defalcation – an assertion Witter cannot make). Summary judgment was reversed because the Court found a control relationship between Titan and the independent contractor-perpetrator. *Id.*

The Fifth Circuit applied the standard to hold a broker-dealer liable on a claim based on a registered

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[4] See *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1575 (9th Cir. 1990), *cert. denied*, 111 S.Ct 1621 (1991), overruling *Christoffel v. E.F. Hutton & Co., Inc.*, 588 F.2d 665 (9th Cir. 1978).

[5] Those may be elements of the "good faith" defense provided by §20(a), but they cannot be established under the case law of any circuit on a motion for summary judgment. The broker-dealer must, at trial, carry the burden of persuasion that its supervisory system was adequate and that it reasonably discharged its responsibilities under that system. *Hollinger*, 914 F.2d at 1576.

representative secretly conspiring with others to manipulate the price of stock. *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111, 1119 (5th Cir. 1980).

The same result was reached in the Fourth Circuit where a registered representative induced investors to buy real estate interests from persons having no relationship with his broker-dealer employer by falsely stating the firm handled private financing of such projects. *Hunt v. Miller*, 908 F.2d 1210, 1215 (4th Cir. 1990).

In fact, Witter in its Petition acknowledges that these circuits have applied the "control" standard in a manner consistent with that of the Seventh Circuit in this case. (P. 10).

However, the Petition claims that the Second and Third Circuits require that §20(a) liability be based on something more than mere control. (Pet. 9-10). Petitioner's position is erroneous. In *Rochez Brothers, Inc. v. Rhoades*, 527 F.2d 880 (3d Cir. 1975) on which the petition relies, the Third Circuit expressly recognized that Section 20(a) imposes a more stringent duty on broker-dealers than that under a "culpable participation" standard.

> **This duty is imposed to protect the investing public and make brokers aware of the special responsibility they owe to their customers.**

Id. at 886. Since *Rochez Brothers*, the Third Circuit has twice upheld vicarious liability under the Act without "culpable participation". *See Sharp v. Coopers & Lybrand*, 649 F.2d 175 (3d Cir. 1981), *cert. denied*, 455 U.S. 938

(1982)[6]; *Eisenberg v. Gelrod, Fox & Co.*, 766 F.2d 770, 784 (3d Cir. 1985).

Likewise, the Second Circuit applies a control standard functionally identical to the standard here. *See Marbury Management, Inc. v. Kohn*, 629 F.2d 705, 716 (2d Cir. 1980), cert. denied, 449 U.S. 1011 (1980). In *Marbury Management, Inc.*, control was assumed because of the relationship between the brokerage house and the wrongdoer. Specifically, the brokerage house employed the wrongdoer as a "lawfully licensed registered representative." At 707.

Thus, contrary to Petitioner's position, there is no conflict among the circuits on the "control" standard, and no need for this Court to grant certiorari.

III. THERE IS NO BASIS FOR WITTER'S CLAIM THAT PLAINTIFFS KNEW OR SHOULD HAVE KNOWN THE CONTROLLED PERSONS' CONDUCT WAS UNAUTHORIZED.

Kenning was hired by Witter, and was paid $50,000 front money to join Witter, three months before his first fraudulent representations injured investors. (F. 239-40, 355). Kenning had been conducting the fraud as a Witter

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[6] Coopers & Lybrand's petition for certiorari declared the issue was whether vicarious liability was imposed by the Act " . . . when a jury has found that no partner in defendant accounting firm acted recklessly or with intent to defraud and that it was not foreseeable to defendant that plaintiffs would suffer any injury from defendant's allegedly misleading tax opinion letter?" Docket No. 81-433, quoted in 50 U.S.L.W. 3329 (Oct. 27, 1981).

salesperson for 14 months before he met Harrison, convincing him, as he had convinced over 100 persons before him, that Kenning's apparent authority to solicit investments in securities through Witter included authority to solicit funds needed to complete bond purchases in a Witter program. (H. 491, C. 115-116). Harrison made repeated contact over the period of the fraud by calling Kenning at Witter's Boca Raton branch. (H. 318-322, H. 66).

Witter has again, as it has in every brief and memo filed since this case began, asserted that there is no issue of fact as to what Harrison knew or should have known. To support this assertion, Witter presents as fact matters that Harrison emphatically denies, asks the Court to draw inferences that are contrary to sworn testimony, and asserts that such representations and inferences should support Witter's motion for summary judgment. It was the grant of summary judgment by the district court which the Seventh Circuit Court of Appeals correctly reversed.

When deciding a motion for summary judgment, the district court must treat as true all factual inferences resolved *against* the moving party (Witter) and in favor of the party opposing the motion. Summary judgment is not the appropriate occasion for weighing evidence; at the summary judgment stage, Harrison (as the non-moving party) was entitled to have the credibility of *his* evidence as forecast assumed, his version of all that is in genuine dispute accepted, and all internal conflicts in the evidence resolved favorably to him; *Blanchard v. Peerless Ins. Co.*, 958 F.2d 483, 489 (1st Cir. 1992). *Dowden v. Polymer Raymond, Inc.*, 966 F.2d 1206, 1207 (7th Cir. 1992). Witter

(the moving party) again presents inferences drawn by its attorneys as "facts", but drawing inferences favorable to a moving party is forbidden in ruling on a motion for summary judgment. *Drexel v. Union Prescription Centers, Inc.*, 582 F.2d 781, 789 (3d Cir. 1978).

The facts Harrison presented and the denials he made under oath in his deposition and affidavit demonstrate the investment program was presented to him, and to the other 125 victims, by Vice-President Kenning as a Dean Witter program. Each victim had been told the same story (K. 501), i.e., Witter had a program designed to attract and retain large producers of gross revenue for Witter. (K. 71, H. 491, C. 115-16). The program was said to buy municipal bonds at only 1/16th or 1/8th of a point over the "bid" price, made possible because of the large number of bonds Witter's traders bought in each transaction. (K. 485, 71). There was no Witter mark-up on these bonds by Witter because direct purchase was limited to select "big producers", like Kenning and Carpenter. Under the Witter program, Kenning stated Witter did not prohibit the participants from obtaining funds from outside their own resources to pay for the special program bonds.

Kenning told the investors that Witter financed 70% of the purchase price of these bonds (K. 488), and that Kenning-Carpenter shared the profits they realized with persons who provided some of the cash needed to participate in the Witter program. Each investor was given promissory notes, which assured Harrison (and the others) he would be paid the tax-free gain (the coupon interest on the bonds) which his funds supported; Kenning and Carpenter were to keep the taxable capital gain.

(K. 492). Kenning always represented to Harrison that Kenning's own direct investment was larger than those he shared with the others. (K. 71-72, 88-89, Dep. of 4-18-88).

Harrison furnished investment money on 17 occasions; the aggregate came to over $4.0 million. (P. App. 2). As fictional bonds acquired with these investment funds "matured", Kenning urged Harrison to "roll" his proceeds into a new bond position. (K. 345-46). Usually he did so, but at times Harrison requested the return of some of his capital. Harrison received $800,000 in response to such requests. On several occasions Harrison offered to open accounts at Witter, but Kenning put him off. (K. 489).

IV. BOTH LEGISLATIVE HISTORY AND JUDICIAL INTERPRETATION SUPPORT THE SECTION 20(a) HOLDING.

The 1934 Act includes a savings clause which provides that "[t]he rights and remedies provided by this chapter shall be in addition to all other rights and remedies that may exist in law or in equity." 15 U.S.C. §78bb(a). Respected scholars have concluded:

> These savings clauses are eloquent testimony to the absence of any intent to preempt common law secondary liability. Quite the contrary these provisions were aimed at *extending* liability.

9 Loss & Seligman, *Securities Regulation*, 4477 (1992).

There is no disagreement among the circuits respecting the legislative purpose of §20(a). Congress intended

to protect the investor in a highly sophisticated field. *Hecht v. Harris Upham & Co.*, 430 F.2d 1202, 1207 (9th Cir. 1970). Contrary to Witter's assertion, the courts recognize that Congress incorporated agency principles into §20(a) to *expand* the scope of liability in order to hold broker-dealers responsible for the acts of their employees. *SEC v. Management Dynamics, Inc.*, 515 F.2d 801, 812-13 (2d Cir. 1975). The statute was intended to supplement, and not to supplant, common law theory as a basis for vicarious liability in securities cases. *Hollinger*, 914 F.2d at 1576-77.

All circuits now agree with the analysis of legislative history and intent incorporated in *Paul F. Newton & Co.*, 630 F.2d at 1118-19. The remedial purpose of the federal securities acts requires a brokerage firm that provides an employee with the means to carry out fraudulent practices to pay damages unless it can sustain the burden of proving the "good faith" defense to the trier of fact. The rights provided victims of such fraud under the common law of agency and under §20(a) were intended by Congress to be, and they are, cumulative. *Id.* at 1118. At the time *Paul F. Newton & Co.* was published, the Third Circuit and the Ninth appear to have interpreted §20(a) less broadly, but both have since conformed. *See Hollinger*, 914 F.2d 1564; *Sharp* 649 F.2d 175 (agreeing that the securities laws expanded the scope of vicarious liability, but that it should not be widely expanded).

V. THERE IS NO CONFLICT WITH ALL (OR ANY) OTHER INTERPRETATIONS OF SECTION 20(a).

Witter's assertion that there is a conflict between the Seventh Circuit's §20(a) standard "and all prior interpretations" is baseless. (Pet. 14-15). Further, the assertion rests on a claim that is worse than baseless in that it is contradicted everywhere in the record. The thoroughly discredited claim is that "Witter had and undisputedly enforced" a system that would have insured that Harrison and the other 125 victims ("any reasonable non-customer") understood Witter had not authorized the Kenning-promoted transactions. What is undisputed is that none of the 125 *did so understand.*

Without registration by a broker-dealer, Kenning could not possibly perpetrate this type of fraud. What kind of a supervisory system is required to prevent frauds by persons who, but for their registration by the control person, would be unable to perpetrate such frauds? One answer would be a system that would vigorously inquire into how a 25-year old registered representative (Carpenter), through whose Witter account millions of dollars passed, was able to make same-day settlement on the purchase of 97,000 OEX put contracts over 30 months, and was able to pay Witter realized losses of $1,844,000. The system would contemplate close questioning of a registered employee who was realizing such losses when his branch manager (and numerous people in Witter's compliance department) knew he had failed in the quest that brought him from Illinois to Florida (i.e., to become a PGA Tour golfer), and had never held a job before joining Witter (September 1983) that paid more

than $5.00 per hour. (F.Ex. 83; C. 12, 17). The system would also require vigilance by the Director of Compliance, whose staff had fired off seven wires to the Boca Raton branch manager over eleven months in 1984 pointing out a "significant number of options" being purchased in the Carpenter account. (Pl. App. 179-186). Nothing was done by the branch manager. Vigorous enforcement would require more from the Director of Compliance than his expressed conclusion that on this record the branch manager was doing a superb supervisory job. (R. 148). The branch manager believed that nothing in the Carpenter account history required managerial concern because, "[Carpenter] was paying with good money. I had no reason to disbelieve anything." (F. 746).

On the facts that came before the branch manager every day and those that were regularly presented to higher levels of management throughout the period of Witter's control, the question is whether the control person took adequate precautionary measures to prevent injury caused by an employee, whether it supervised the fraud perpetrators in an adequate and reasonable fashion and whether it diligently maintained and diligently implemented its system of control. *Hunt v. Miller*, 908 F.2d at 1215. There is nothing in the Seventh Circuit's opinion that implies Witter must tap and continuously monitor all employee telephone conversations, verify the source of *all* funds, etc. as paraded in Witter's Petition. (P. 15). However, to establish the "good faith" defense, a trier of fact may well expect a broker-dealer to have vigorously inquired into the source of the nearly $3 million deposited by young Mr. Carpenter, and into how the Kenning-

Carpenter team obtained funds to settle losses over 30 months of nearly $2 million when one claimed a net worth of $25,000 and the other was going through bankruptcy. The refusal by the Seventh Circuit to affirm summary judgment on these facts is anything but dramatic, and it certainly is not singular.

CONCLUSION

There is no conflict between the circuits respecting the standard of control required of broker-dealers in respect to their registered employees under §20(a). The Seventh Circuit decided this issue in a manner that comports with both Congressional intent and consistent judicial interpretation of the statute. For these reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted this 29th day of April, 1993.

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